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June 23, 2005

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Lyn A. Farmer
Administrative Law Judge
Hearing Division
Arizona Corporation Commission
1200 W. Washington
Phoenix, AZ 85007

Arizona Corporation Commission

DOCKETED

JUN 23 2005

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Re: *AEPCO's Finance Application; Docket No. E-01773A-04-0793;*
Staff Report dated June 14, 2005 ("Staff Report")

Dear Lyn:

I understand that you may prepare the recommended opinion and order ("ROO") on this matter and wanted briefly to provide you AEPCO's response to the Staff Report. AEPCO does not object to Staff's recommendation that action on its finance request be tied to the Commission's action on AEPCO's rate case in Docket No. E-01773A-04-0528 (the "Rate Case"). However, while AEPCO and Staff have agreed upon revenue requirements and recommended rates in that matter, if the Commission were to order some different level of rates, AEPCO still believes its finance application should be approved.

AEPCO also would urge the Commission not to condition these loans' approval on AEPCO's commitment "to adopt a plan concurrent with its rate case to improve its capital structure by increasing the patronage equity portion to at least 30 percent" as recommended at page 4 of the Staff Report. Instead, AEPCO suggests the subject of equity structure and equity analysis is best left to the Commission's decision in the rate case where the matter has been discussed at hearing and fully briefed.

As background and for convenience, attached as Exhibit A are pages 6-9 of AEPCO's Rate Case Closing Brief filed on May 9, 2005 which discuss this issue. In the Rate Case, Staff has recommended that the Commission establish a firm equity goal and that the target should be set at 30%. AEPCO's position is that the Commission should take no action on those subjects in the Rate Case, because the issue of what is, and how rapidly AEPCO should reach, a particular

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and appropriate equity level has never been carefully analyzed. Rather, it recommends that it file, as recommended by Staff, an equity analysis by March 31, 2006. Following that filing, the Commission could take up the matter in a subsequent proceeding or perhaps AEPCO's next rate case.

For the same reasons AEPCO has discussed in the Rate Case, it also urges the Commission not to adopt Staff's recommended condition of a 30% equity structure in this finance application order. We appreciate your attention to this matter and are hopeful that both this order and the rate case decisions can be decided by the Commission at its July Open Meeting. AEPCO waives the ten-day exception period to assist in accommodating that request.

Respectfully submitted,

GALLAGHER & KENNEDY, P.A.

A handwritten signature in black ink, appearing to read "Michael M. Grant", with a long horizontal flourish extending to the right.

By:

Michael M. Grant

MMG/plp
10421-39/1280513

Attachment

Original and 13 copies delivered to
Docket Control this 23rd day of June, 2005.

cc: Lyn Farmer, Hearing Division (delivered)
Tim Sabo, Legal Division (delivered)
Diane Targovnik, Legal Division (delivered)

1 that the revised depreciation rates should be approved by the Commission (Jerry D. Smith
2 Memorandum, S-22).

3 Demand Side Management

4 As a wholesale generator, AEPCO does not agree with Staff's recommendation that it
5 engage in DSM programs. While AEPCO will assist its Arizona Class A member distribution
6 cooperatives if they are required to implement such programs, Mr. Minson in his rebuttal
7 testimony outlined several reasons why such programs are best designed and administered at the
8 local distribution cooperative level—not at the generation level (AEPCO 2, pp. 11-12).

9 Initially, this appeared to be a subject of disagreement between Staff and AEPCO.
10 However, in her surrebuttal and hearing testimony, Ms. Keene clarified that while Staff believes
11 that AEPCO should design and implement DSM programs, that issue does not need to be
12 addressed in this Order. Instead, it can be reserved for a Commission decision in the DSM Rules
13 matter, Docket No. RE-00000C-05-0230 (HR TR, pp. 216-217 and 219-221). Pending the
14 decision in the Rules docket, AEPCO agrees that this Order should contain an authorization for
15 recovery of Commission-approved DSM program costs based on whatever Rule is adopted later
16 this year.

17 **AREAS OF DISAGREEMENT***

18 Equity Improvement

19 AEPCO and SWTC do not agree with the Staff recommendations that this Order should
20 establish firm equity goals for either Cooperative and strongly disagree with Staff's 30% target
21 equity level. Both Cooperatives, however, do agree with Staff that building equity is important
22 and their records on this issue demonstrate that commitment. In AEPCO's case, following

23 _____
24 * The following two issues are common to both AEPCO and SWTC. They will be addressed jointly and
incorporated by reference in the SWTC Closing Brief.

1 extremely adverse 1980s economic events, including a recession and loss of 125 MW in copper
2 mining loads, AEPCO was able to increase equity as a percentage of assets from a negative
3 14.9% to a positive 7% from 1991 to 2002 (Minson Rebuttal, AEPCO 2, pp. 8-9). In SWTC's
4 case, it only commenced operations in late 2001. But, its test year equity was approximately
5 4.7% (HR TR, p. 139, ll. 19-22) and absent other changes, the level of margins requested in this
6 case would build its equity ratio to 15% in about ten years (Minson Rebuttal, SWTC 2, p. 3).

7 However, while equity is an important factor in judging the Cooperatives' financial
8 strength, it is only one element among many other important factors. Both Mr. Edwards and
9 Mr. Minson discussed that issue at hearing (HR TR, pp. 60-64 and 99-100). Mr. Ramirez also
10 agreed that many different elements—not just the equity level—impact a cooperative's financial
11 health (HR TR, p. 243, l. 22-p. 245, l. 17). Referring to pages 1-3 of his surrebuttal exhibit
12 AXR-2 (S-14), Fitch Ratings looked at some 12 different factors in assigning a rating to Golden
13 Spread Electric Cooperative including, but not limited to, the strength of its requirements
14 contracts, management quality, adequate liquidity, overall financial profile, DSC and TIER
15 results as well as its equity level. Neither the Cooperatives nor the Commission want to be in the
16 difficult position in the future where potentially unnecessarily high rate increases would be
17 driven by an equity target which had been set inflexibly or without adequate consideration as to
18 its correct level.

19 There also is ample evidence here that the equity level of 30% recommended by Staff is
20 simply too high for a generation or transmission cooperative. Mr. Minson testified that, subject
21 to Board approval and the preparation of additional analysis, his opinion as Chief Financial
22 Officer of both Cooperatives is a reasonable equity level would be in the 15-20% range (HR TR,
23 p. 147, l. 24-p. 148, l. 16).

1 Consistent with that position, Mr. Ramirez' Exhibit AXR-2 (S-11 and S-12) is a listing of
2 some G&T cooperatives which are rated by Standard & Poors. Only two of the 13 rated
3 cooperatives listed have patronage equity levels above 30%. The remaining 11 have equity
4 levels ranging from 26% to as low as 8%, but still carry S&P ratings. The average is only 19%.
5 As Mr. Edwards testified, G&T cooperatives nationwide had a median equity ratio at the end of
6 2002 of only slightly more than 13%—well below Staff's recommended target equity level of
7 30% (Edwards Direct, AEPCO 6, p. 10 and Edwards Direct, SWTC 5, p. 9). Finally, as
8 Mr. Minson noted, in a survey conducted by R.W. Beck in 2002, the median equity goal for
9 G&T cooperatives responding was only 17.5% (Minson Rebuttal, AEPCO 2, p. 9).

10 The most important factor here is that these issues have never been carefully analyzed
11 with specific reference to the numerous factors which impact the financial strength and needs of
12 AEPCO and SWTC. Staff points to the Commission Decisions and Capital Plans which AEPCO
13 and SWTC filed in response to those Decisions at the end of 2002 (Late Filed Exhibits, April 20,
14 2005). However, these were only Capital Plans, not equity analyses. They simply set forth what
15 the then current financial forecasts indicated based on a number of stated qualifications and
16 assumptions. Further, both Cooperatives expressed then the same concerns expressed here about
17 focusing only on equity levels:

18 [T]he financial strength of a cooperative is evaluated in light of several factors
19 including the strength of member service territories, load projections and
20 economic forces and not just on a predetermined level of equity. AEPCO's
21 [Southwest's] future equity levels will be judged and determined in light of these
22 and other factors. AEPCO [Southwest] will attempt to balance the needs of its
23 members for the lowest possible rates while continuing to maintain AEPCO's
24 [Southwest's] ability to attract sufficient funds for capital improvement and
expansion. (AEPCO Capital Plan, p. 6; Southwest Capital Plan, p. 5.)

23 As suggested by Staff, AEPCO and SWTC will prepare an equity analysis and will file it
24 with the Commission by March 31, 2006. Both Cooperatives will use that process to carefully

1 analyze these issues, consult with their lenders and seek advice and reactions from their Boards
2 and members. As importantly, the products will give the Commission important, Cooperative-
3 specific information that it does not have now.

4 In the interim, the Cooperatives request that the Commission take no action on these
5 subjects in this Order. Following the filing of the equity analyses next year, these issues can be
6 re-addressed, if needed, in the Cooperatives' next rate cases.

7 Finally as to this subject, while neither AEPCO or SWTC have any intention of making
8 patronage capital refunds in the foreseeable future, the Cooperatives do not object to Staff's
9 recommendation that they comply with the requirements of 7 CFR Part 1717 concerning
10 patronage capital refunds (Exhibits S-23 and S-24; HR TR, p. 251, l. 5-p. 252, l. 16). They also
11 do not object to Mr. Ramirez' recommendation that each Cooperative file another rate case
12 within at most three to five years of the effective date of this Order.

13 Anza Cost of Service Study

14 AEPCO and SWTC ask that the Commission not require in future rate cases a separate
15 cost of service study for Anza, a Class A member distribution cooperative located in south-
16 central California. Anza is a very small cooperative which joined AEPCO and its five other
17 Arizona Class A members in 1979. In the three rate cases which have been conducted since that
18 time, the Commission has never required, nor has Staff recommended, a jurisdictional separation
19 study for Anza.

20 Anza's load and the revenues it provides AEPCO and SWTC are quite small—in
21 AEPCO's case they were only 1.5% of its total energy sales in 2003 (Minson Rebuttal,
22 AEPCO 2, p. 7). Mr. Minson testified that the estimated cost of preparing such a study would be
23 in the range of \$40-60,000 and cost of service differences for Anza, if any even exist, would
24 justify neither the expense of preparing such a study, nor the Staff and Commission effort